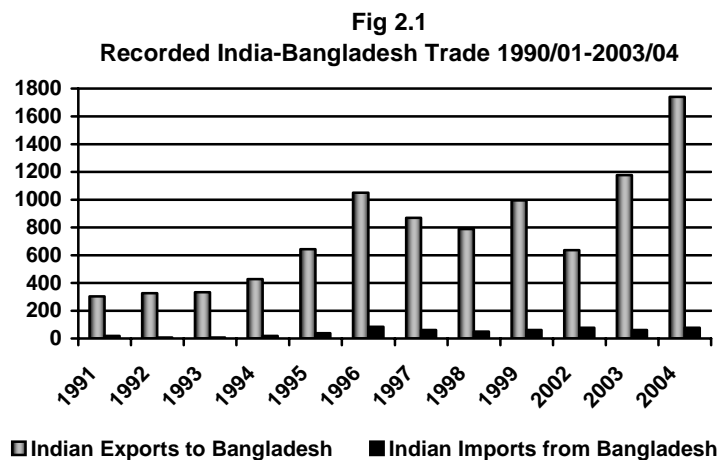
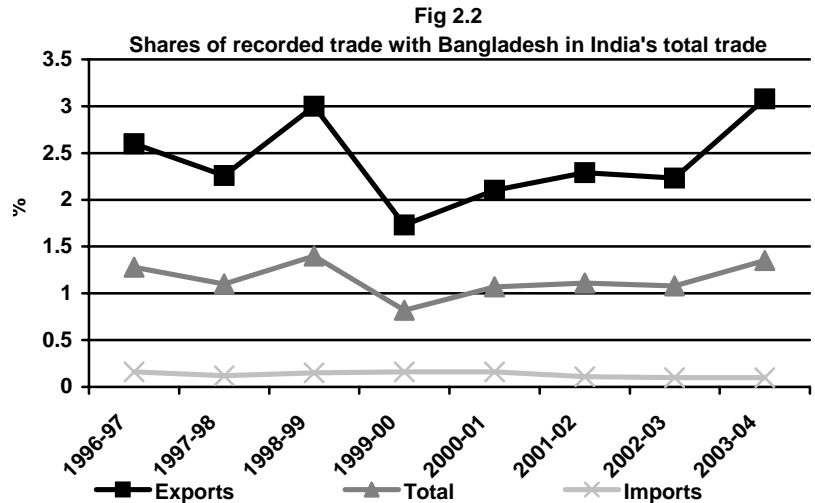


## Chapter 2: Background: bilateral trade and exchange rates

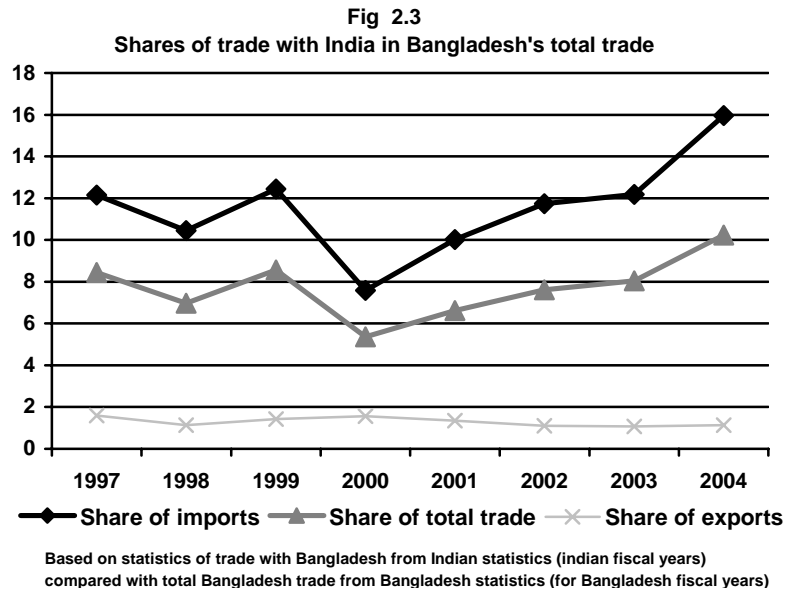
In 2004 India's officially recorded exports to Bangladesh were about \$1.7 billion but its imports from Bangladesh were just \$78 million. Indian exports to Bangladesh grew very rapidly during the 1990s, and have continued to grow since 2000 (Fig 2.1). By contrast Bangladesh exports to India-almost zero in the early 90s-have stagnated at very low levels at well below \$100 million annually. In inflation adjusted US dollars they are presently about the same as they were 20 years ago during the 1980s. Since 1996/97 Indian exports to Bangladesh (in nominal US dollars) have been growing at 9.1% annually, just slightly above the general rate of growth of its total merchandise exports (8.4%), but India's imports from Bangladesh over the same period have grown on average at only 3% annually, compared to average growth of its total imports of 9.2%. Consequently Bangladesh's bilateral trade deficit with India has been increasing rapidly, on average at about 9.5 % annually.



For India, trade with Bangladesh is a very small part of its total trade—just over one percent since the mid-1990s, and currently about 3 percent of its total exports and a minuscule share (0.01%) of its total imports (Fig 2.2). For Bangladesh (Fig 2.3) however, India has now become the largest single source of its imports (about 16% of the total, ahead of China and Singapore) and accounts for about a tenth of its total trade, despite exports to India which have declined to only slightly above 1 % of total exports.



Most Bangladesh imports from India come via the land border<sup>6</sup>. According to incomplete Bangladesh data, during the 1990s about three quarters of imports were by land and river, but this proportion has declined since then to between 50 and 60 percent (Fig 2.4). These statistics do not include duty free (“back to back L/C”) imports from India of inputs—mainly textiles—for Bangladesh’s export industries, but most of these probably also come by the land border. One reason for the decline in the share of the land border trade is a requirement imposed by Bangladesh in July 2002 that two major imports from India—sugar and textile yarns—could henceforth only be imported by sea. The reason given for these measures was the control of illegal activities and smuggling at or near the land border Customs posts, and immediately afterwards there was a big jump in officially recorded imports of sugar from India which presumably came by sea<sup>7</sup>. However, a more basic reason for the decline in the share of the land border trade is increasing congestion and delays at the land border crossings—especially at Petrapole-Benapole—as a result of inadequate infrastructure and administrative capacity on both the Indian and the Bangladesh sides, in the face of rapidly increasing total volumes of trade.



Studies of informal trade between India and Bangladesh have consistently found a similar pattern to the pattern of formal trade i.e. large volumes of goods being smuggled from India to Bangladesh, but much smaller volumes being smuggled in the other direction. This general conclusion that there is also a substantial Indian trade surplus on informal account, is confirmed once again in the studies done as part of this project.

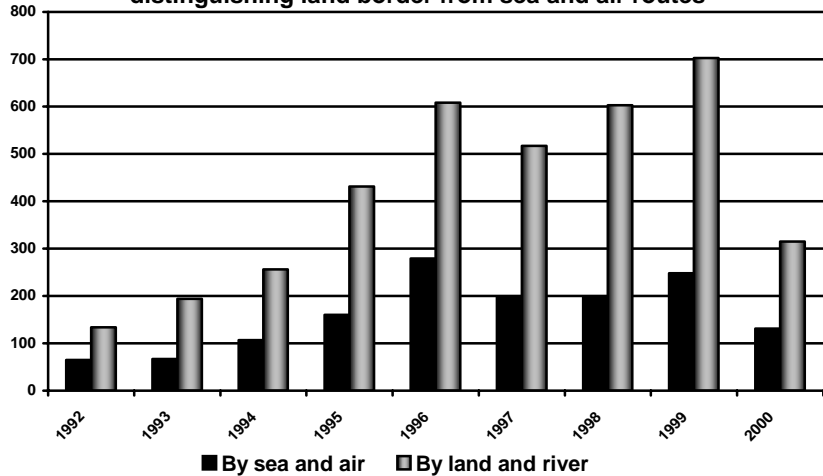
<sup>6</sup> We were unable to obtain equivalent statistics on the land/sea breakdown of Bangladesh exports to India.

<sup>7</sup> There is no product breakdown of the land border and sea trade. The consultant studies did not report Indian statistics distinguishing the land and sea trade with Bangladesh

In the past, a major reason for the expansion of Indian exports to Bangladesh (and also to the other South Asian countries) was the massive devaluation of the Indian Rupee, which started in about 1985 and finished in 1992. The Rupee devaluation (Fig 2.5) up to 1992 supported India's trade liberalization during this period, and is best interpreted as a return to a more normal and economically efficient situation, following many years of extreme exchange rate overvaluation, during which India's exports to the world as a whole, including the other South Asian countries, were taxed and compressed. Since 1992 the real value of the Rupee (as indicated by the Rupee REER index) has been kept at approximately the same level, with adjustments of the nominal exchange rate offsetting differences in inflation in India and average inflation in its trading partners. While this was happening, the real value of the Bangladesh Taka (Fig 2.6) moved within a fairly narrow band of about 10% around trends of slow devaluation from 1980 up to 1996, modest appreciation from 1997 to 1999, followed by slow but steady devaluation which was still continuing in early 2005. The strength of the Taka since the mid-1980s has

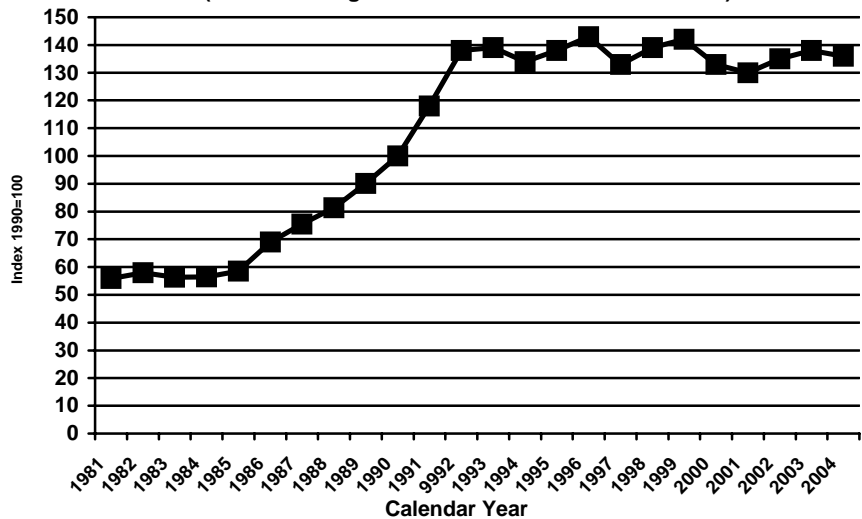
reflected the strong growth of ready made garment exports and of remittances from Bangladeshis working outside the country, which together have been sufficient to balance increases in imports resulting from import liberalisation measures, especially the removal of many QRs and the reduction of tariffs in the early 1990s. However, one consequence of the relatively stable Taka alongside the devaluation of the Rupee between 1985 and 1992, was that the Taka/Rupee rate appreciated in real terms by about 30% (Fig 2.6). This appreciating trend of the real Taka/Rupee exchange rate continued at a slower pace until, in 1999, the total real appreciation of the Taka in relation to the Rupee was about 50%, compared to its value in the mid 1980s. Since about 1999, this trend has been reversed, with the real Taka/Rupee exchange rate devaluing on average at about 4 % per year, about the same as the average rate of real devaluation of the Taka viz a viz the rest of the world.

**Fig 2.4**  
**Bangladesh imports from India FY 1992-2004:**  
**distinguishing land border from sea and air routes**



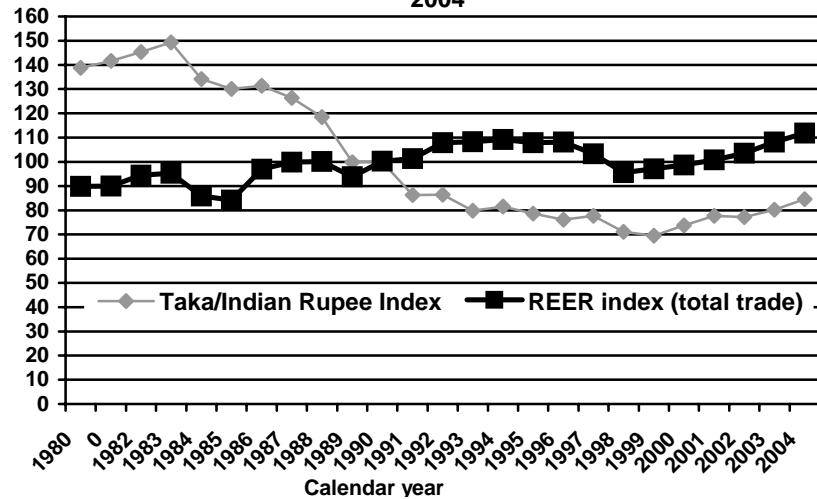
Note: data is for Bangladesh fiscal years. It excludes Indian duty free exports used as inputs by Bangladesh exporters ("Back to Back LC imports") and imports through some small land border customs posts.

**Fig 2.5**  
**India Real Effective Exchange Rate Index 1980-2004**  
**(Annual averages 1990=100: Increase=devaluation)**



The persistent and substantial appreciation of the real Taka/Rupee exchange rate from the mid-1980s up to about 1999, combined with Bangladesh's liberalization of its import policies, are plausibly important reasons for the expansion of recorded formal Indian exports to Bangladesh over this period. Conversely, the Taka appreciation would have retarded the growth of formal, recorded Bangladesh exports to India during the same period. However, as noted above, recorded Bangladesh imports from India have grown even more rapidly since the exchange rate

**Fig 2.6**  
**Bangladesh Real Exchange Rate Indices 1980-2004**



trend was reversed after 1999, and Bangladesh exports to India have continued to stagnate. This is consistent with observations in a number of the consultant studies that efficiency and productivity have been growing in India, especially in Indian manufacturing, resulting in an acceleration of general export growth, a very small part of which has consisted in rapid growth of exports to Bangladesh. Faster productivity growth in India would have also increased the difficulty of Bangladesh exports competing there, offsetting the favourable trend in the exchange rate since 1999. This is also consistent with the consultant studies, which for a sample of products found that most prices-especially prices of manufactured goods-were markedly higher in Bangladesh than in India.

Rupee devaluation and faster productivity growth in India would also tend to increase informal Indian exports to Bangladesh, while retarding informal Bangladesh exports to India. However, in this case import liberalisation would be expected to divert some of the growth of informal trade into formal channels. There is support for this latter hypothesis in the study on informal trade, which finds that informal imports from India had somewhat declined in absolute terms compared to informal imports estimated by earlier studies, but were markedly lower relative to the total volume of formal recorded imports from India.

In popular discussions of economic policy in Bangladesh, some groups see the bilateral trade deficit with India as a problem, and use it to argue against both general trade liberalisation, and preferential or free trade with India. However, the trade deficit with India has been consistently offset by trade surpluses with other countries, especially with the US and the EU, and by worker remittances. These surpluses have in turn supported the exchange rate of the Taka with other currencies, including the Taka/Rupee rate, and have both enabled, and have been a consequence of, macroeconomic policies which have avoided destabilizing fluctuations in the balance of payments, domestic prices and the exchange rate. As in other countries, there is no economic logic in the idea that trade should be balanced with individual trading partners, and the real concerns behind contrary arguments are usually efforts to prevent or moderate import competition.<sup>8</sup>

<sup>8</sup> Bangladesh also consistently runs large trade deficits with developing countries in East and South East Asia. In this respect the Bangladesh public debate on trade which focuses on the trade deficit with India, resembles the US public discussions on the US bilateral trade deficit with China.

Alongside popular concerns in Bangladesh about the trade deficit with India, it is also often argued that the deficit is aggravated by protectionist policies that have hobbled Bangladesh exports to India. However, as noted above, for the past 8 years India's imports from the world as a whole have been growing at over 9 percent a year: on average, each year's increase in imports has been exceeding Bangladesh's total exports. Many of these imports have been coming in over considerably higher tariffs than the tariffs faced by Bangladesh exporters, owing to the extensive tariff preferences given to Bangladesh by India under SAPTA, and to the extent that there are non-tariff and bureaucratic barriers, they are probably more constraining than the ones that Bangladesh would face<sup>9</sup>. This suggests that the low level and slow growth of Bangladesh's exports to India reflect fundamental comparative advantage factors, not discriminatory import policies.

This issue is also considered in the consultant studies in the light of what is likely to happen were there free trade between India and Bangladesh. The general finding of the studies is that some aspects of India's import regime are retarding Bangladesh exports, but that in the short and medium run the potential for expanded exports to India is not very great, even under an FTA or with the full implementation of SAFTA. On the other hand the studies also find very recent and strong protectionist trends in Bangladesh's import policies which are a major constraint on Bangladesh imports in general and which, if still enforced against the rest of the world during an FTA with India, would lead to a large expansion of imports from India and an increase in Bangladesh's bilateral trade deficit.

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<sup>9</sup> An example is Indian anti-dumping, which has been concentrated on developing countries, especially China and other East and South East Asian countries. For the products which it affects, it provides protection in the Indian market for exporters in countries not subject to anti-dumping duties. See further discussion in section 3 below.

